Basics of Stock-Based Incentive Awards

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Stock Options

Under U.S. tax rules, a compensatory stock option may be either an incentive stock option ("ISO") or a non-qualified stock option ("NQO"). (But see, also, the discussion of employee stock purchase plans, below.) The income tax treatment of the two is different for both the employer and the employee. For purposes of the discussion of NQOs, reference to "employees" is meant to include other stock option recipients who provide services as independent contractors. Generally, on the exercise of an NQO, an employee will recognize ordinary income equal to the excess of the then value of the stock over the exercise price, and the employer will be entitled to a corresponding deduction. On a subsequent sale of the stock, the employee will recognize gain or loss, with the basis equal to the value of the stock at the time of option exercise. On exercise of an ISO, the employee will recognize no income or gain. On the sale of the stock, and assuming certain requirements (discussed below) are satisfied, the employee will recognize capital gain or loss with the basis equal to the option exercise price. The employer ordinarily receives no deduction with respect to an ISO absent a disqualifying disposition by the employee.

Generally, an option will *not* be treated as an ISO unless certain requirements are satisfied, including:

(1) The plan under which the ISO is granted must be approved by the shareholders within 12 months before or after the date the plan is adopted by the board of directors of the company.

(2) The plan under which the option is granted must specify the aggregate number of shares which may be issued as ISO shares.

(3) The ISO must be granted within ten years of the date on which the plan is adopted.

(4) The aggregate fair market value of stock (determined on the date of grant) with respect to which ISOs are exercisable for the first time during a calendar year may not exceed $100,000. To the extent that value of the stock subject to options exceeds that amount, the excess shall be considered to be NQOs, with the determination to be made in the order the options are granted.

(5) The option exercise price may not be less than the fair market value of the stock determined at the time the option is granted. (Special rules apply if the recipient owns more than 10% of the combined voting power of all classes of stock of the company or its parent or subsidiary companies.)

(6) The option may not be exercisable after the date that is ten years after the grant. (Special rules apply if the recipient owns more than 10% of the combined voting power of all classes of stock of the company or its parent or subsidiary companies.)

(7) An ISO may not be transferable except by will or by the laws of descent and distribution, and during the employee's lifetime, may be exercisable only by the employee.

(8) To obtain favorable ISO tax treatment, the following requirements must be satisfied: (i) the option must be exercised while the recipient is an employee, or within three months after the recipient's termination as an employee; provided that, in the case of termination on account of disability, the exercise period may be extended to one year; and further provided that the

employment requirement is waived in the case of the employee's death; and (ii) no disposition of the option stock may be made before two years from the date of grant or one year from the date of transfer.

(9) An option will be treated as an ISO if it satisfies all of the requirements otherwise applicable to ISOs, but only if it is not designated at the time of grant as an NQO.

Stock Options - Early Exercise Procedures

The following outlines the structuring and tax consequences of a pre-vesting exercise of a non-qualified option ("NQO"), including use of a loan to satisfy the exercise price. The discussion applies to a company with shares that are not publicly traded.

Generally.

The grant of an NQO will not result in taxable income to the optionee. Except as described below, the optionee will realize ordinary income at the time of exercise in an amount equal to the excess of the fair market value of the shares acquired over the exercise price for those shares, and the company will be entitled to a corresponding deduction. Gains or losses realized by the optionee upon disposition of such shares will be treated as capital gains and losses, with the basis in such shares equal to the fair market value of the shares at the time of exercise.

Payment with Shares.

The company could permit the exercise price to be paid with previously-acquired shares of company stock. Often, however, this is not permitted until after the shares of the company become publicly traded. The exercise of an NQO through the delivery of previously-acquired stock will generally be treated as a non-taxable, like-kind exchange as to the number of shares surrendered and the identical number of shares received under the option. That number of shares will take the same basis and, for capital gains purposes, the same holding period as the shares that are given up. The value of the shares received upon such an exchange that are in excess of the number given up will be includible as ordinary income to the optionee at the time of the exercise. The excess shares will have a new holding period for capital gain purposes and a basis equal to the value of such shares determined at the time of exercise.

Early Exercise.

To enable an optionee to have all appreciation in the covered shares treated as capital gain, the company will sometimes permit the optionee to exercise the option before it is "vested." Because of the complexity of this procedure, as well as the administrative and financial burden it imposes on the optionee and the company, it is sometimes limited to a small group of founders and senior executives.

If the option permits exercise before vesting, the stock acquired upon exercise will ordinarily not vest until the option would have vested. Accordingly, if the optionee leaves the employ of the company prior to the date on which he or she would otherwise have vested in the option, the company will be entitled to repurchase the option stock, by paying the lesser of the option exercise price previously paid by the optionee or the fair market value of the stock at the time of repurchase.

For all of the appreciation after exercise to be treated as capital gain, the optionee must elect to have the income recognized and measured at the date of option exercise. The amount of any income recognized would be equal to the excess of the fair market value of the stock at the date of exercise (without regard to the risk of forfeiture) over the exercise price. The company would be entitled to a deduction equal to the amount of any income recognized. As a result of the election, the applicable capital gain holding period would commence as of the exercise date. Such an election, permitted under section 83(b) of the tax code, must be filed with the IRS not later than 30 days after the date on which the option is exercised. If the option is exercised at the time it is granted, the election would typically not result in the recognition of income, because the value of the stock would equal the exercise price. At the time of disposition of the stock, any gain or loss would be a capital gain or loss, with the optionee's basis in such shares equal to the fair market value of the shares at the time of exercise.

If filing the section 83(b) election results in a recognition of income at the time of exercise, and the optionee subsequently forfeits the appreciation, the optionee would not be permitted to recognize a tax loss, but the company would be required to reverse its prior deduction.

If the optionee does not make a timely filing of a section 83(b) election, he or she would not recognize taxable income at the time of exercise of a non-vested option, because the appreciation on the shares would be subject to a "risk of forfeiture." At the time the stock vests (i.e., when the risk of forfeiture lapses), the optionee will realize ordinary income in an amount equal to the then fair market value of those shares, reduced by the amount previously paid by the optionee, and the company will be entitled to a corresponding deduction. Gains or losses realized by the optionee upon disposition of such shares will be treated as capital gains and losses, with the optionee's basis in such shares equal to the fair market value of the shares at the time of vesting.

In some cases, if the optionee exercises the option before it is vested, he or she is provided with a loan from the company to pay the option exercise price. To avoid imputation of taxable income, the loan must bear interest at the applicable Federal rate. To achieve the desired tax and accounting consequences, the optionee must be personally liable for payment of the loan. The loan is typically not payable until the earlier of the date the stock is sold by the optionee, or a specified period after the optionee's date of termination with the company.

Restricted Stock

The most traditional type of restricted stock awards involve the grant of shares of stock of the company, with vesting based solely on completion of a specified period of service. Restricted stock may also provide that the vesting of the shares will be contingent on the achievement of performance goals, or the achievement of performance and/or service requirements. Stock units are a type of stock-based award that is are closely related to restricted stock. Vesting restrictions may apply to stock unit awards. However, the grant of stock units does not reflect current ownership of shares, but rather the right to receive delivery of shares of stock at a later date. Typically, the share units will accrue dividends during any deferral period, which may be credited to the employee's account as additional stock units, or may be paid in cash (either currently or on a deferred basis). Another type of award that is related to restricted stock is a performance share or performance unit award. These awards provide the opportunity to receive stock, or a designated dollar amount based on the value of stock, subject to the achievement of performance or other objectives.

Employee Stock Purchase Plans

The term "employee stock purchase plan" or "ESPP" typically refers to a plan that permits purchases of employer stock at regular intervals. Generally, these purchases are paid for by the employee with money obtained through payroll deductions. At the end of the period, the accumulated sums are applied to purchase employer stock. Typically, no brokerage fee is charged on the purchase. Often, the plan permits the purchases to be made at a discount from the fair market value of the stock. If an individual is employed at a public company, stock of that company is typically used. If an employee is employed at a subsidiary of a public company, then stock of the public parent is typically used. ESPPs are rarely used when none of the affiliated companies have stock that is publicly traded.

Tax code § 423 provides favorable tax treatment to employees participating in an ESPP that satisfies certain requirements. Most U.S. employers with ESPPs conform their plans to the requirements of tax code § 423. Although § 423 characterizes the purchase of stock under an ESPP as being pursuant to the exercise of an option, such plans usually do not resemble typical stock option plans.

For plans that do not satisfy tax code § 423, the payroll accumulation period is often between one and three months. For plans that do satisfy tax code § 423, the accumulation period is often six months. Pricing rules, and related tax and accounting considerations for § 423 plans, are the principal reasons behind the difference in lengths chosen for typical payroll accumulation period. Ordinarily, payroll deductions are capped at about 10% or 15% of pay.

Tax code § 423 permits discount pricing of stock. Generally, § 423 permits a purchase price equal to not less than the lesser of 85% of stock's fair market value at the beginning of the payroll deduction period or 85% of stock's fair market value at the end of the payroll deduction period. Often, the plan provides that the stock may be purchased at the lesser of these two amounts. It is generally possible to have a two-year measurement period for purposes of determining the fair market value, with purchases more frequently (e.g., every six months).

Checklist for Stock-Based Awards

The following outlines the principle considerations in connection with the grant of stock-based compensation awards:

Type of Award. What type of award will be granted: option (ISO or NQO); SAR; restricted stock; performance units?

> **Eligibility.** Who will receive awards? If a non-employee is to receive an award, is that permitted under the plan? Will awards to non-employees be subject to different terms?
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> **Size of Awards.** How large will the award be? Does the size of the award comply with any limits provided in the plan? What will be the source of the stock - authorized and unissued, treasury, market purchases?
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> **Vesting.** What will the vesting schedule be? Will it be service-based vesting, performance-based vesting, or a combination? What is the effect of a change in control? If any acceleration occurs on a "change in control," how will that term be defined? Will the definition of "change in control" be consistent with other arrangements for the company?
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> **Restrictions.** Is there any restriction on competition or the like associated with the award or its vesting?
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> **Sale of Shares.** Are there limits on an employee's ability to sell shares acquired under the plan? For closely-held companies, does the employee have right to put shares back to company, and does the company have the right to call the shares?
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> **Options - Transfer.** Are unexercised options transferable?
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> **Options - Reloads.** Will reloads be permitted?
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> **Options and SARs - Exercise Price.** What is exercise price? How should the stock value be determined? Is the valuation method consistent with past practice?
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> **Options and SARs - Exercise Price.** What forms of payment will be accepted in settlement of the requirement to pay the exercise price? Will the employee be permitted to pay the exercise price through the delivery of previously owned company stock or with the a promissory note? How will tax withholding be satisfied?
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> **Options and SARs - Expiration.** For options and SARs, what is expiration date? What happens to the option on termination of employment? Does the reason for termination of employment affect vesting or exercise period?
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> **Restricted Stock - Dividends.** For restricted stock, will there be distribution of dividends prior to vesting?
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> **Legal and accounting compliance.** Insider trading rules of § 16 (SEC Rule 16b-3); $1 million limit (tax code § 162(m)); SEC registration requirements; golden parachute issues (tax code §§ 280G and 4999); accounting issues.

Current Issues

Proxy disclosure rules of stock awards. On January 29, 2001, the SEC proposed rules that, if adopted, would require disclosure by public companies of: (i) the number of securities that have been authorized for issuance by the registrant's board of directors; (ii) the number of securities issued pursuant to equity awards made during the last completed fiscal year, plus the number of securities to be issued upon the exercise of options, warrants or rights granted during the last completed fiscal year; (iii) the number of securities to be issued upon the exercise of outstanding options, warrants or rights; and (iv) other than securities to be issued upon the exercise of outstanding options, warrants or rights, the number of securities remaining available for future issuance. (SEC Release Nos. 33-7944, 34-43892; File No. S7-04-01.)

Dealing with reductions in stock price. The price of the stock for many companies has dropped substantially over the last several months, and is currently less than the exercise price for many previously granted options. (That is, the options are "underwater" or "out of the money.") The drop in stock price, resulting in underwater options, has created employee relations issues for many companies (both for unexercised options and options that were exercised prior to vesting). The following are some alternatives used by companies in connection with unexercised underwater options.

- **Re-price existing options at today's FMV.** The company, with the employee's consent, may cancel the existing options and grant new options with a lower exercise price. The new options might cover fewer shares that the number covered by the canceled options, and could have a vesting schedule that is the same as or different from the vesting schedule of the canceled options. Offering the holder of an incentive stock option ("ISO") a choice to exchange his or her option for a new option at a lower price is likely to preclude favorable ISO tax treatment to the employee for the original option if the exchange offer is not accepted. In addition, such "repricing" of options may generate an adverse reaction from shareholders, unless the repricing is first approved by the shareholders. Also, repricing will result in variable accounting treatment for the repriced options. Finally, as a condition of receiving favorable ISO tax treatment, the employee may not dispose of the shares for at least two years from the date of grant. This two year period would restart at the time the replacement ISO is granted.
- **Exchange options for restricted stock.** The company could grant a restricted stock award to an employee in exchange for the employee's agreement to cancel outstanding options. Generally, this approach would not result in variable accounting, although the company would incur a charge to earnings equal to the value of the stock, to be amortized over the vesting period.
- **Grant new/additional options to employees.** New options or restricted stock could be granted to employees without cancellation or revision of the outstanding underwater options. However, this may result in granting stock compensation in excess of what would be viewed as reasonable by the Board of Directors or by shareholders. It would also result in having a larger number of shares subject to outstanding awards, and thus use up shares reserved under the plans.
- **Exchange program.** With the employee's consent, outstanding options could be canceled. At the time of the cancellation, no new awards or other compensation would be granted. After a period of at least 6 months after cancellation, new options could be granted to the employees, with an exercise price that is not less than the fair market at the time of the new grant. This approach should not result in variable accounting. This arrangement may need to be treated as a self tender for securities law purposes.
- **Overlapping options.** New options could be granted having an exercise price equal to the current value of the stock. The option would expire on the earlier of the date of expiration of the currently outstanding underwater options or a date that is 6 months and one day after the first date that the company's stock price exceeds the exercise price of the current underwater options. Under the recent pronouncement of the Financial Accounting Standards Board Emerging Issues Task Force, in Topic No. D-91, this arrangement should not result in a charge to the company's earnings.

Withholding on ISOs and ESPP options. In Field Service Memorandum 199926034, the IRS concluded that FICA taxes should apply to certain transactions under employee stock purchase plans (ESPPs). On January 18, 2001, the IRS issued Notice 2001-14, which generally provides that income tax, FICA, and FUTA withholding would not be due with respect to ESPP and incentive stock option transactions occurring prior to January 1, 2003. The notice also indicates that it is the intent of the IRS to require withholding on these types of transactions occurring on or after that date, but solicits comments on this issue.

Rabbi trusts and employer stock - Notice 2000-59. Many employers maintain one or more so-called "rabbi trusts" to set aside funds for non-qualified deferred compensation plans maintained for management employees. Generally, a "rabbi trust" is a trust that is used to provide funding for non-qualified deferred compensation arrangements. To satisfy tax law requirements, a rabbi trust must be subject to the claims of creditors of the employer. Recently, in regulations issued under tax code § 1032, and in IRS Notice 2000-56, the IRS indicated that a rabbi trust which holds parent company stock to be used to provide benefits for employees of a subsidiary company would generally not result in adverse tax consequences to the parent or the subsidiary, but only if the trust assets are subject to the claims of creditors of both the parent company and the subsidiary company. Any required amendment to a trust should be made by May 16, 2001, to avoid adverse tax treatment.

Constructive receipt guidance. IRS representatives have indicated that the IRS may issue formal guidance during 2001 regarding constructive receipt issues arising under elective deferrals of compensation.

Pooling of interests accounting treatment for transactions. The design of stock-based awards may affect the accounting treatment for business combinations. The accounting for such combinations can be performed using either of two methods: purchase accounting and pooling-of-interests accounting. In comparison to purchase accounting, the use of the pooling method often provides the advantage of allowing lower depreciation and amortization charges. (In many cases, pooling treatment is so much more favorable than purchase accounting that the transaction will only be completed if pooling accounting treatment is available.) Pooling treatment is available only for stock-for-stock transactions, and many recent transactions have been structured to allow the use of this method. The complex pooling rules require, among other things, that stock and stock-based compensation awards not be granted or altered in contemplation of the combination within two years prior to the transaction, and that only common stock of the surviving entity be exchanged for substantially all of the voting common stock of the other enterprise. These and other rules can substantially limit the ability to adjust stock-based compensation in connection with and prior to the transaction if pooling accounting treatment is sought. Also, the requirements of pooling accounting treatment may require modification of certain types of awards. On February 14, 2001, FASB published a revised exposure draft "Business Combinations and Intangible Assets - Accounting for Goodwill." The standards set forth in the draft would, if adopted, substantially avoid the problem which is otherwise avoided through the use of pooling of interests accounting.

The 2nd Annual Spring Meeting BUSINESS LAW SECTION